Jens Weidmann: The euro – political project and prosperity promise

Introductory statement by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Rencontres Économiques d'Aix-en-Provence, Aix-en-Provence, 7 July 2013.

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1 Introduction

Ms Boone, Mr Beytout, Mr Lahoud, Mr Papantoniou, Mr Reynders, Mr Védrine

Ladies and gentlemen

It is a great pleasure for me to be here today. I am very happy to be back here in Aix-en-Provence, a place which brings back so many fond memories. In a way, one could say that I have come full circle: 25 years ago, I came to Aix as a student eager to learn and discuss economics and Europe – and, of course, to enjoy student life in this beautiful Provençal city. Today, I intend to do the same. Unfortunately, this pertains only to the first part.

2 The euro – political project and prosperity promise

Whenever the topic of conversation turns to economics and Europe, the euro normally takes centre stage – today more than ever. But it is worth remembering that the euro was also a political project from the very outset. Back in 1949, the French economist Jacques Rueff declared that money would pave the way for European integration: "L'Europe se fera par la monnaie ou ne se fera pas."

50 years later, Jacques Rueff's vision took shape. But the integration brought about by the economic and monetary union was by construction an asymmetric one. Monetary policy was united. But fiscal and structural policies remained matters of national responsibility, albeit subject to coordination rules that sought to address the deficit bias inherent in this institutional setting.

This was in keeping with the principle of subsidiarity as enshrined in the European Treaties. It was also supposed to be in keeping with the principle of liability, as spelled out in the no-bail-out clause, which sought to complement the coordination rules by fostering market discipline with regard to fiscal policy. And it was in keeping with the primacy of monetary stability by virtue of an independent European System of Central Banks and the prohibition of monetary financing.

Together with the rules laid down in the Stability and Growth Pact, these precautions were designed to contain the tensions inherent in a framework that combines a single monetary policy with 17 national economic policies.

Besides being designed to promote stability, the euro promised to foster prosperity as well. Hopes were high that the euro would set in motion a process of real convergence. It was expected that governments would have no choice but to implement structural reforms and improve their supply side, since stimulating demand would no longer be an option. Fiscal policy was supposed to be bound by the rules of the Stability and Growth Pact and by the disciplining effect of the financial markets; monetary policy, meanwhile, would no longer be available to national policymakers at all.

We now know that things did not quite work out as expected. That poses a fundamental question: do we need to shift economic policies to the European level to make monetary union viable? Or will it suffice to amend the existing framework?

In my remarks, I wish to argue that both avenues can in principle lead to a stable framework. The changes required to amend the current framework are by no means trivial. But it is my impression that, at the current juncture, they might be more feasible than giving up national sovereignty in fiscal and economic matters.

3 A stable framework for a prosperous monetary union

The crisis can be read simultaneously as a sovereign debt crisis, a balance of payments crisis and a financial crisis. But in my view, there is one basic economic principle which goes a long way towards explaining it: people respond to incentives.

And in the case of Europe, implicit guarantees for banks and sovereigns caused shareholders, investors, governments and voters to ignore, or worry less about risk. Underestimated contagion effects between countries exacerbated these effects. In the end, the balance between liability and control – which is essential for any market economy – had got out of kilter.

This, for me, largely explains the unsustainable developments in the run-up to the crisis. And this is what needs to be changed for the euro area to regain its footing.

In terms of the implicit guarantee given for sovereigns, a genuine fiscal union would be a path towards establishing a framework which balances liability and control. In this scenario, control and intervention rights would be shifted to the European level. If this prerequisite were fulfilled, a greater mutualisation of liabilities would become feasible – and may be justified.

But it seems to me that giving up national sovereignty in fiscal matters does not enjoy a majority in Europe at this juncture – neither among politicians nor among the general public in the member states. President Hollande's recent response to the European Commission's recommendations for reform is a case in point: "Elle n'a pas à nous dicter ce que nous devons faire."

And mutualising debt without mutualising control would exacerbate the tensions inherent in EMU's framework rather than eliminate them. It therefore would not resolve Europe's woes, but only make matters worse. It would not, in particular, preserve the currency union as a stability union.

So for me, the only feasible way forward is to strengthen the framework laid down in the European Treaties. This implies stiffening the fiscal rules which were stretched and ignored too often in the past, with Germany being one of the culprits.

The new Stability and Growth Pact is a step in the right direction. But the mere existence of these rules does not suffice. We need to actually apply them. Softening the rules would be a step backwards. The European Commission recently suggested taking public investment out of the deficit calculation. In my view, this only serves to make the procedure arbitrary and intransparent.

In addition to stronger rules, we need to make sure that in a system of national control and national responsibility, sovereign default is possible without bringing down the financial system. Only then will we really do away with the implicit guarantee for sovereigns.

To achieve this, we have to sever the excessively close links between banks and sovereigns. Currently, European banks hold too many of their own governments' bonds. This is because banks do not have to hold any capital against their government debt, as the risk weight assigned to sovereign bonds is zero. To counteract excessive investment in sovereign bonds, we need to change the capital rules for these bonds to make sure they are adequately risk-weighted; and we need limits for banks' exposures to sovereigns, as is already the case for private creditors. Only then will banks be able to cope with the repercussions of sovereign default.

Getting to grips with the implicit guarantee for sovereigns would be a big step towards eliminating the inherent tensions in the monetary union's structure. Removing the implicit guarantee for banks would be another one.

To make that happen, we have to ensure the resolvability of banks. Defining a clear hierarchy of creditors is crucial. Shareholders and creditors will have to be first in line when it comes to bearing banks' losses – instead of taxpayers. And to further strengthen market discipline, the establishment of a single supervisory mechanism for systemically important banks as well as a single resolution mechanism will be an important step forward. In this regard, a common resolution regime will have to ensure that banks without a viable business model can exit the market in an orderly fashion.

Such a regime is crucial not only for financial stability, but for sustainable growth as well. A functioning resolution regime strengthens incentives for effective credit monitoring and moderates banks' risk appetites. In so doing, it enhances the allocation of capital and reduces the risk of a bubble emerging.

Better still would be if banks didn't reach the point of having to be wound down in the first place. In this regard, higher capital requirements are a big part of the solution – the single supervisory mechanism is another.

4 The role of monetary policy

These are necessary steps that will put the euro area back on the path to prosperity. Finally, please allow me to make a few short remarks on the role of monetary policy during the crisis. Monetary policy has already done a lot to absorb the economic consequences of the crisis, but it cannot solve the crisis. This is the consensus of the Governing Council. The crisis has laid bare structural shortcomings. As such they require structural solutions.

"Structural reforms may hurt a few vested interests, but they would clearly strengthen the effectiveness, competitiveness and, yes, also the fairness of our economies." Those are Mario Draghi's words, not mine. I agree, however.

The best contribution a central bank can make to a lasting resolution of the crisis is to fulfil its mandate: that of maintaining price stability. And this is what Jacques Rueff actually meant when he made that famous statement in 1949. As David Marsh has pointed out, it was a declaration of support for common principles of monetary stability rather than an early advocacy of a single currency. We should not jeopardise now what we have fought so long to achieve.

5 Conclusion

Ladies and gentlemen, let me conclude.

Monetary union has always been both a political project and a prosperity promise. To fully unleash the common currency's potential, efforts are needed on two fronts: structural reforms as well as the abolition of implicit guarantees for banks and sovereigns.

But I did not come here to preach; I came here to discuss, to listen, and to learn. So without further ado, I would like to hand over to our moderator, Nicolas Beytout.